

India August MPC decision: Will this be a non-event?

We agree with the consensus polls that the RBI led Monetary Policy Committee (MPC) is likely to maintain status quo on both rates and stance in the 6-8th August policy decision. Also, we expect it to be a 4:2 decision, as was in June policy, with Dr. Varma and Dr. Goyal as dissenters, in their last monetary policy meeting as the tenure ends as MPC members in end September.

However, this policy may not be a “non-event” like June, given the sharp change in global macro backdrop since last policy, on sudden shift in US Fed rate cut expectations. Domestically, concerns regarding elevated food inflation persist with impact of 7% monsoon surplus with uneven distribution closely watched while financial (in)stability concerns continue to warrant RBI’s attention. The recent switch in banking system liquidity with a favorable outlook as the government has budgeted for a drawdown in cash balance also requires careful management in order to align the call rate with policy rate.

On balance, despite the expectation of no change in this policy, the language and guidance on the various competing global and domestic drivers in the MPC’s policy reaction function would be closely watched. More importantly, any steps towards liquidity management and macroprudential measures to address financial (in)stability would stay in focus. In our view, the RBI is likely to continue with fine-tuning operations.

Global recession poses downside risks to domestic macro projections

The sharply weaker than expected US July jobs data has triggered the Sahm rule, historically accurate predictor of US recession and hence led to global recession worries. This poses downside risks to the MPC’s FY25 GDP and CPI projections of 7.2% and 4.5% given various global linkages through trade, sentiment and commodity price channels. As per the April Monetary Policy Report, a 100bps drop in global growth vis-à-vis the baseline (3.1%) poses risk of drop in GDP and CPI forecast by 30bps and 15bps respectively.

Hence, trends in high frequency growth indicators need close watch with slight moderation in pace already seen in Q1-FY25 amid election related uncertainty and lagging government spending. From the inflation perspective, downward pressure on commodity prices supports a favorable outlook especially for core CPI and WPI even as geopolitical tensions may cap the impact.

Amidst heightened global macro uncertainty, we expect the MPC to keep FY25 growth and inflation projections unchanged and stay data dependent.

Monsoon is a key domestic risk driving food inflation

The projected drop in headline CPI to 4.5% in FY25 from 5.4% last fiscal is contingent on fall in food inflation. The latter has been a key pain point averaging 7.6% in FY24 with latest print for June also at an elevated 8.4%. In this regard, monsoon trends are on close watch after El Niño led rainfall worries last year. Hence, the latest print of 7% cumulative rainfall surplus as of 6th August 2024 bodes well for crop sowing and overall food inflation dynamics yet uneven spatial distribution is a cause for concern (Pls see: [India: Turnaround in monsoon in July’24 bodes well](#)).

After rising to 5.06% in June, we see inflation cooling to 3.74% in July, primarily led by base effects in food. However, sequential momentum in food prices continues to remain elevated, even as some cooling recently in cereals, pulses and edible oils prices provides relief. In specific, we are watching for trends in vegetables prices even as surplus rains have shown some salutary effect. Vegetables inflation at c.30% YoY has been prime inflation driver while CPI ex vegetables has been subdued at c.3.5%.

Liquidity in surplus mode and requires careful management

Banking system liquidity was broadly in deficit from Sep’23 on elevated government cash balance (averaged c.Rs 2.5 lakh cr in FY24) and start of busy season. While core liquidity has been consistently in surplus mode, headline (or frictional) liquidity slipped into surplus for a brief period in end March/early April and now has been back in surplus mode since end-June. The recent trends have been driven by drawdown of government cash balance, seasonal fall in currency leakage and resurgence of FX flows on JPMorgan EM bond index inclusion. With government budgeting for a drawdown in cash balance to the tune of Rs 1.4 lakh cr in current fiscal, outlook for liquidity has turned favorable. FPI flows also likely to contribute positively to liquidity as Fed starts rate cutting cycle while the RBI led MPC may delay, in our view.

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With RBI conducting OMO sales in secondary market to the tune of c.Rs 10,105 cr in recent weeks, there has been growing speculation regarding announcement of liquidity absorption steps in this policy meeting like OMO sale auction calendar, FX swaps, CRR among others. However, in our view, the RBI may stick to fine tuning operations (VRRR, VRR, etc.) and closely watch the liquidity dynamics amid macro and market uncertainty. Any macroprudential measures especially for addressing credit excesses (post unsecured credit, NBFC ex HFCs) will be in focus.

Financial (in)stability warrants attention; need to resolve the “conundrum between CD ratio and real rates”

As highlighted on our recent research, [India – Conundrum between C-D Ratio and Real Rates](#), the need for higher real rates is a combination of higher potential growth along with rise in (perceived) inflation. The latter has led the households to “hunt for yield” and allocate a large part of savings away from bank deposits to asset classes - equity, real estate and gold - all clocking much higher returns in recent years vis-à-vis long-term average. This has driven structural slowdown in low-cost CASA deposits and raising cost of funds for the banking system. This has led to fight for deposits by banks witnessing credit-deposit growth wedge during high growth phase with C-D ratio at record highs and incremental C-D ratio at close to 100%. HDFC merger effect exacerbating the impact duly acknowledged by RBI as well in the Financial Stability Report. The interesting part is that the share of physical savings in total household savings at 70% is similar to taper tantrum period which also saw a loud call for higher real rates.

In this regard, we agree with the recent RBI study (“Updating Estimates of the Natural Rate of Interest for India with Post-Pandemic Evidence”) concluding uptick to 1.4-1.9% vs 0.8-1.0% using earlier study conducted during covid period. In our view, the RBI is required to maintain high real rates and stay considerate about the “silent depositor” (a phrase used by the RBI Governor in recent CNBC interview) even as the government is focused on lowering cost of capital via lower market borrowings.

We do not see rate cuts this year; global risks on close watch

We believe that till the financial (in)stability explained above is addressed, the RBI is required to keep rates on hold in our view. Also, food inflation remains a cause for concern and needs a close watch before the MPC can be assured of decline in inflation towards the 4% target and switch in monetary policy cycle. However, we duly acknowledge that global risks need close watch as well with expectations for Fed rate cuts by end of 2024 shifting from 45bps by end-June to close to 100bps currently. This will remain on close radar for the RBI led MPC even though the latter can wait in our view, with relatively stronger growth dynamics providing for space to delay the start of a shallow rate cut cycle.

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